All in all, the latest corporate results have not been as poor as had been anticipated. Consumer-goods stocks flagged, while industrial stocks fared well.

Benjardin Gärtner, Head of Equity Portfolio Management

Market news and expert views

Monthly report November 2022

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The markets at a glance

Summary

The current market environment is characterised by slowing economic growth, high inflation and tightening monetary policy. Increased stress in the financial markets in connection with structural issues created additional tension in recent weeks and negative news emerged in relation to a small number of global financial institutions. The 'mini budget' presented by British prime minister Liz Truss and her government plunged UK government bonds (gilts) and pound sterling into turmoil, with knock-on effects on other bond markets and even the stock markets. UK pension funds were forced to liquidate positions, prompting the Bank of England to make emergency asset purchases at short notice. The resignation of the Chancellor of the Exchequer and the scrapping of most of the original budget policies helped the UK government to calm the situation in the markets and take pressure off the central bank.

Meanwhile, many other negative factors have already been priced in by the capital markets. Based on historical patterns, we still expect that corporate bonds will be the first to turn the corner and recover, followed by equities and, finally, commodities. However, lingering uncertainties mean that it is still too soon for this market recovery.

Nonetheless, our investment decisions are geared towards preparing for this turnaround. The defensive overall positioning is being retained and the strategic focus is firmly on active management, intelligent use of relative positions and careful security selection in order to maximise returns. Our current risk positioning (RoRo meter at level 2) has thus been confirmed. We believe that the capital market environment will remain challenging for a while yet. Consequently, further losses in riskier asset classes cannot be ruled out, especially after a period of recovery. Following a rise in risk premiums, the risk/return profile of investment-grade corporate bonds seems more balanced again to us.

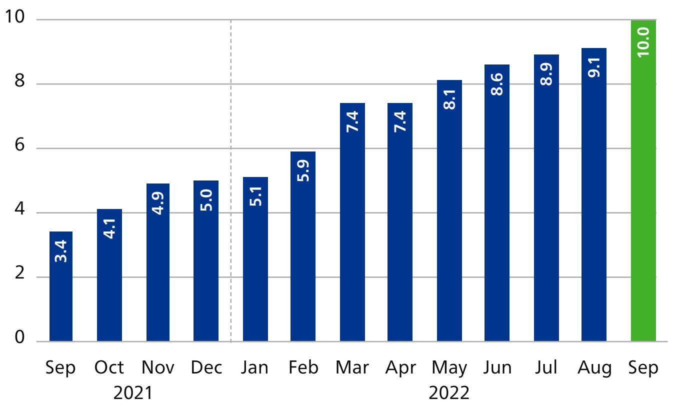
Economy, growth, inflation

Our proprietary leading indicators suggest that the economic slowdown is continuing. The barometers indicate that growth is flagging in the US as well as in the eurozone and in China, although the pace of the cool-down seems to be slower in the US. This assessment is supported by various external indicators, such as surprisingly positive data for US industrial output and the consumer sentiment index published by the University of Michigan. Nonetheless, conditions for growth remain generally weak for now, even though we do not anticipate a steep slump in economic activity. This picture is unlikely to change much in the coming months. In light of recent developments, we have adjusted our growth forecasts for the US and now predict a contraction in gross domestic product (GDP) of 0.2 percent for 2023 as a whole.

The monetary policy of the US Federal Reserve (Fed) will likely be a key driver of the economic downturn. The Fed's determination to curb inflation will probably lead central bankers to overshoot the mark, i.e. tighten monetary policy to an extent that is incompatible with a 'soft landing' for the economy. Without a doubt, the Fed is under pressure to act, even though inflationary pressures have eased somewhat in the US.

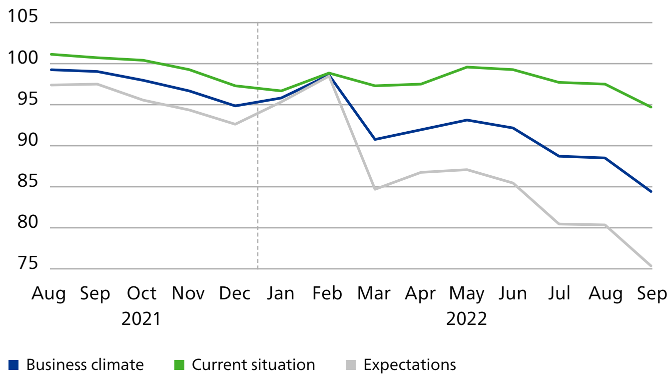
Inflationary pressure in the eurozone remains high, as reflected in data such as producer prices. Unlike in the US, however, the primary driver is not the labour market but the supply of commodities. As a result, consumers are feeling the impact of soaring costs of living while their wages are rising at a much slower rate. Companies across the board are struggling with cost pressures that are pushing their business models to – and sometimes over – the limit. These conditions are having an adverse effect on value creation and investment.

Persistent price pressures prompt monetary tightening
Inflation from September 2021 to September 2022 (%)



Source: Bloomberg, as at 20 October 2022.

Germany seems to have slipped into a recession already
ifo Business Climate Index movements in recent months



Source: Union Investment, as at 20 October 2022.

The markets at a glance

Monetary policy: further tightening on the cards

Given the inflation situation described above, the end is not yet in sight for the tightening of monetary policy. Quite the contrary: More interest-rate hikes are likely to follow in the coming months and some central banks will probably begin to scale back their balance sheets. Whether at the Annual Meetings of the International Monetary Fund and World Bank, in newspaper interviews or at other conferences, central banks worldwide have left little doubt about their resolve. The prevailing mantra when it comes to monetary policy is that inflation has to be brought down.

We expect the US Federal Reserve to raise its key rates by another 75 basis points at its upcoming meeting in early November. This will probably be followed by a hike of 50 basis points in December, taking the target range for the federal funds rate to 4.25–4.5 per cent at the end of the year. For 2023, we expect neither further interest-rate hikes nor interest-rate cuts.

Further tightening of monetary policy is also anticipated in the eurozone, in fact to a greater extent than a few weeks ago. With inflation remaining high and the European Central Bank (ECB) looking increasingly resolute, we have adjusted our forecasts for future monetary policy in the eurozone. Specifically, we predict an interest-rate rise of 75 basis points at the end of October, followed by a further increase by the same amount in December (compared with the increases of 50 basis points implemented so far). We thus expect the deposit interest rate to reach 2.25 per cent by the end of 2022 (currently: 2.00 per cent). A further 50 basis points is then expected to be added in the first quarter of 2023, either with a hike of 50 basis points in February (more likely) or with two increases of 25 basis points in February and March (less likely). The terminal rate for the deposit facility at the end of the cycle of interest-rate rises is thus predicted to be 2.75 per cent.

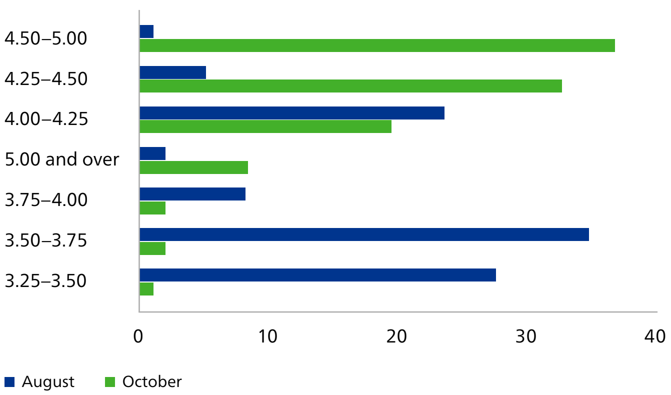
Fixed income: corporate bonds regain appeal

High inflation means that the central banks are maintaining their course and continuing to raise interest rates. Consequently, the tailwind provided for yields in the bond market generally remains intact. Last week, yields on ten-year US government bond yields crossed the 4 per cent mark, while two-year paper is already approaching 4.5 per cent. The inversion of the US yield curve is thus continuing. The picture is similar in the eurozone, where investors are picking up yields of more than 2 per cent on two-year German government bonds for the first time since 2008. As a result of the rise in yields on ten-year Bunds to just over 2.3 per cent, the German yield curve has recently steepened again slightly. Fundamentally, however, it is likely to maintain its flattening trend in view of the interest-rate rises expected to be implemented by the ECB.

The spreads of bonds from eurozone periphery countries are continuing to hold steady. The new Italian government's financial and economic policies are still unclear, so it remains to be seen whether these will lead to significant tensions between Rome and the European Union. For now, Italy's ability to service its debts is assured, although we believe there is a risk of a substantial widening of spreads in 2023 should there be a sharp rise in government spending. Our expectations for corporate bonds are more positive as current spread levels are, in our opinion, an adequate reflection of the economic concerns that have been priced in. Trends in the market for bonds from emerging economies continue to diverge significantly.

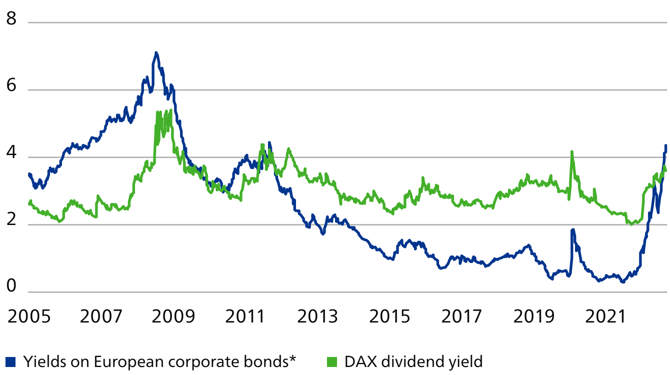
- **Change:** We are neutralising our positions in investment-grade corporate bonds, US Treasuries and government bonds from core eurozone countries.
- **Positioning:** Government bonds from the eurozone periphery are being treated with caution but our view of all other sub-asset classes is neutral.

Market participants expect higher interest rates
Survey result: "Where will the Fed's cycle of interest-rate hikes end?" (%)



Source: BofA Global Funds Manager Survey, as at 18 October 2022.

Appeal of corporate bonds has improved significantly
Long-term comparison since the start of 2005 (%)



*Measured by the ICE BofA Euro Corporate index.
Source: Refinitiv, as at 18 October 2022.

The markets at a glance

Equities: economic environment and interest rates are the main driving factors

The equity markets continue to be affected by faltering growth and rising interest rates. In the current reporting season for the third quarter, the spotlight is therefore on the extent to which deteriorating economic conditions are impacting on companies' revenue and profit. Although companies' outlooks are cautious and many have lowered their forecasts, the initial impression is not as negative as had been feared in some cases. At the same time, the major central banks are maintaining their restrictive approach for now. However, there is a real possibility that the Fed, at least, will reach the end of its cycle of interest-rate rises as the year draws to a close, which may prove helpful for US stock market valuations. And sentiment in the European equity markets, which had been at a heavily oversold level, has now brightened a little following the UK government's policy reversals. The heightened level of stress in the financial markets in connection with structural issues (e.g. pressure on UK pension funds and problems at certain individual banks) has consequently abated again. Nevertheless, our general view of the equity markets remains cautious as profits are weakening, valuations are still not at an attractive level and tackling inflation continues to be the central banks' top priority. The situation in China remains the crucial factor for shares from the emerging markets. The party congress currently taking place in Beijing has not provided any extra impetus so far, and the US government's CHIPS Act, which restricts high-tech exports to China, is putting additional pressure on the country's economy.

- **Change:** None.
- **Positioning:** Equities from industrialised countries are generally unattractive at present. Our assessment of equities from emerging markets is neutral.

Commodities: the fundamentals are improving

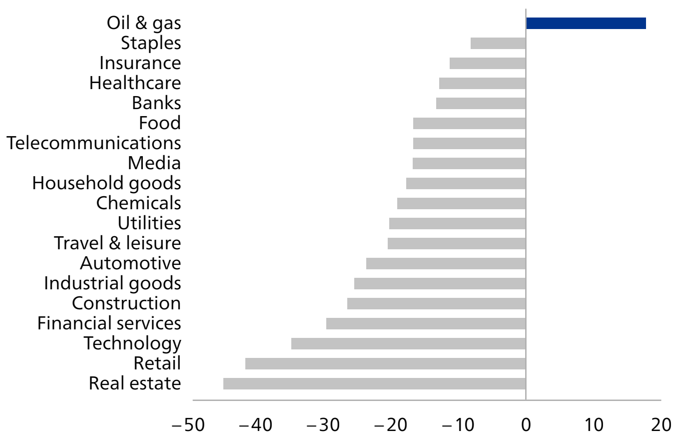
By and large, commodity prices have stabilised in recent weeks. On the one hand, the slowdown of the global economy, the restrictive monetary policy of the major central banks and the strong US dollar are still a source of strain. But on the other, the fundamental market environment is improving for many commodities.

The oil market is moving into equilibrium as global demand declines while at the same time US output increases and OPEC output decreases. Inventories of industrial metals have decreased substantially and mainly now stand at a level that is enough for just a few weeks, which points to a significant supply shortage. However, China's weak economic growth is still forestalling major price rallies for now. In the precious metals segment, many investors disposed of their holdings of gold in the face of rising interest rates and a strengthening US dollar. With roll yields at a high level, the general prospects for commodities have improved slightly. Geopolitical risks remain the price trend 'wild card', harbouring potential for upward as well as downward swings.

- **Change:** None.
- **Positioning:** We are cautious about commodities from the precious metals and energy sectors. Our view of industrial metals is neutral.

High losses across nearly all industries

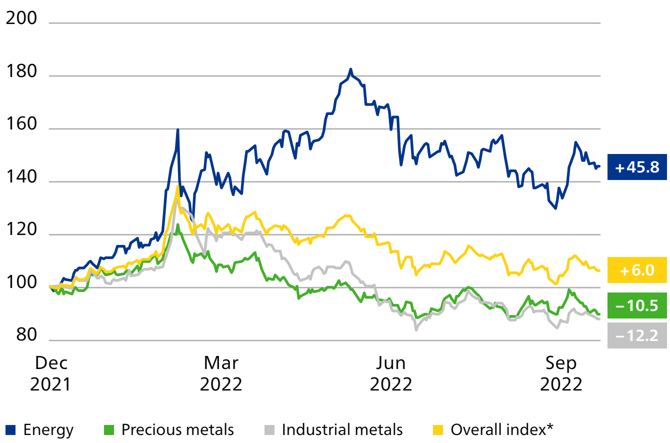
Performance of the STOXX Europe 600 index in the year to date (%)



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

Commodities weighed down by concerns about growth

Indexed performance in the year to date



* MS RADAR ex agriculture & livestock.
Source: Bloomberg, as at 20 October 2022.

The markets at a glance

Currencies: no trend reversal just yet

Most of the trends in the currency markets remain intact. The US dollar is continuing to appreciate, driven by the Fed's determinedly restrictive tone and clear focus on combating inflation, as well as by the still robust position of the US economy compared with that of other economic areas. The Japanese yen has been particularly weak. The Bank of Japan (BoJ) increasingly appears to be the 'last man standing' and is adhering firmly to its ultra-expansionary monetary policy. This situation is unlikely to change until the BoJ's governor, Kuroda, leaves office at the end of March 2023.

Despite attempts by the People's Bank of China to stem the renminbi's rapid depreciation, the currency is continuing to slide. By contrast, European currencies were at least able to consolidate vis-à-vis the greenback in recent weeks, although the underlying trend still appears to point downward. The UK government abandoned large parts of the recently announced budget, which had a calming effect on the capital markets. In the eurozone, the ECB will continue to tighten its monetary policy, bringing it closer to that of the US. This should help the euro to maintain its value against the US dollar going forward. We believe that the Fed will conclude its cycle of interest-rate hikes before the ECB.

- **Change and positioning:** None.

Real estate: office market in Germany

The third quarter was characterised by high inflation and rising interest rates as well as growing uncertainty about the outlook for economic growth.

The rolling twelve-month average volume of lettings in the five biggest German office markets – Berlin, Düsseldorf, Frankfurt, Hamburg and Munich – stood at 3.2 million square metres at the end of the third quarter of 2022. This represents another slight quarter-on-quarter increase. Consequently, the average vacancy rate held steady. At 5.7 per cent, it was on a par with the second quarter, but up by 40 basis points year on year. Hamburg remains the city with the lowest vacancy rate (3.5 per cent).

High-quality office space in good locations is still in short supply. As a result, companies looking to relocate in two years' time are already starting to secure the space they need. This has driven rental prices up by 1.6 per cent on average. While rents in Berlin and Düsseldorf trended sideways, Frankfurt, Hamburg and Munich saw increases of between 2.3 per cent and 3.1 per cent. Year on year, prime office rents are up by as much as 5.3 per cent on average. The proportion of vacant office properties that are new (or as new) can be expected to decline sharply over the coming quarter while the proportion of older, unrenovated properties is likely to rise.

In light of the interest-rate environment, investors that are highly reliant on borrowed capital have been holding back noticeably. As a result, office property transactions in the third quarter of 2022 were down by 50 per cent compared with the prior-year quarter.This pushed average initial yields up by 10 basis points.

We anticipate moderate growth in prime rents as new and recently modernised properties will remain in limited supply and high demand. Higher financing costs mean that initial yields will also continue to rise moderately.

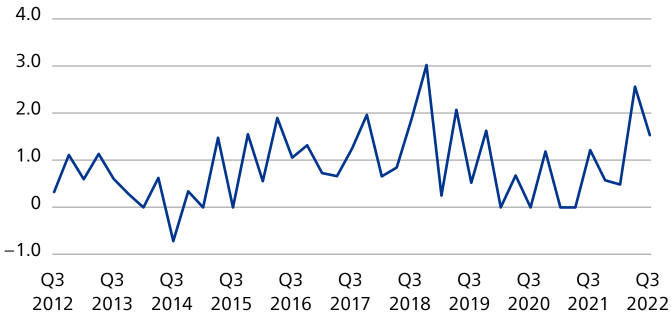
UK government relents and reverses tax cuts

US dollars to pound sterling since 10 September 2022

Source: Bloomberg, as at 20 October 2022.

Quarterly change in prime office rents in Germany

Average (%)*



* Average of the five biggest German office markets.
Source: JLL, as at 30 September 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. Increased stress in the financial markets in connection with structural issues has recently created additional tension.
- The economic environment is continuing to weaken. We expect that the pace of economic growth will slow in China, the US and the eurozone.
- Inflation remains high and will come down only slowly. This suggests that the end is not yet in sight for the tightening of monetary policy.
- Our general risk assessment (RoRo meter) remains at level 2 (slightly defensive).

RoRo meter

Source: Union Investment, as at 19 October 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. We are no longer taking a negative view of corporate bonds.
- **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:** The US dollar continues to strengthen, but will probably face stronger headwinds going forward.
- **Commodities:** Commodity prices are stabilising as improved fundamental conditions, on the one hand, combined with adverse pressures from the economic slowdown and monetary policy, on the other, are roughly balancing each other out.
- In the short term, we are keeping funds parked in **cash**. The cash position is now earning interest again and has thus regained 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 19 October 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 30 November 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 **24 October 2022**.

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