Letter from CIOs

MANUELA D'ONOFORIO – HEAD OF GROUP INVESTMENT STRATEGY
PHILIP GISDAKIS – CHIEF INVESTMENT OFFICER GERMANY
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Below the surface

The first half of this year has been characterised by a number of stress factors for the economy and financial markets:

1. Central banks around the world have embarked on a monetary tightening path due to persistently **high inflation**. For the US, in particular, this gives rise to the risk that the Federal Reserve's (Fed) measures could cool economic growth significantly – even to the point of a mild recession.

2. The **war in Ukraine continues** and with it the risk of energy supply disruption for Europe – a risk scenario that is becoming more apparent to investors in light of Russia's recent cutbacks in gas supplies to Germany and Italy.

3. The recent **Covid wave in China**, to which the Chinese government has reacted with very strict lockdown measures, is on the one hand slowing the Chinese economy (affecting demand for European export goods) – while on the other hand, however, further straining the already tight supply chains (this also has a negative impact on Europe, especially on the manufacturing sector).

As a result, it appears there is only bad news from all sides. However, these burdens are partly external factors that may only have a **temporary effect**. Regarding the effects of Covid-related measures, for example, we know that they only have a temporary impact on the economy if the crisis is managed adequately, and that one can expect catch-up effects when the measures are relaxed again. Although the approach of the Chinese government with its strict zero-Covid strategy and the comparatively low level of vaccination protection, especially among vulnerable groups, cannot be directly compared with the situation in Europe and the US (the burdens could last longer than in the western industrialised nations), experience teaches us that Covid infections come in waves, which therefore should also subside again.

At the beginning of the year, expectations for economic growth in Europe and the US were still focused on a noticeable post-Covid recovery. There were strong signs that the economy was taking hold and could benefit from noticeable catch-up effects. This recovery has been interrupted by the war in Ukraine. The key channel through which this conflict is affecting the economy is further increases in energy and commodity costs and, in particular, concerns about energy supply disruptions for those countries heavily dependent on Russian oil and gas imports – a risk that has moved a little closer with the recent developments1. However, these risks are external. If the situation regarding energy and raw material supplies eases, one could certainly expect a link to the expectation of a post-Covid recovery.

Looking below the surface, there are certainly signs that can give confidence. In particular, the latest ifo report on the mood of the German economy, which is also an important stock market barometer for the entire Eurozone, sends positive signals. In particular, the ifo range on the order situation of companies should be mentioned here: the order reach of German industry has not been as high as it is at present since the beginning of the 1990s.

Finally, persistent inflationary pressures play a central role – and it leads to central banks raising interest rates to cool down price dynamics. In particular, inflation in the euro zone is rushing from record to record. It made another strong move in May, cracking the 8% mark. However, the exact characteristics of the inflation dynamics are a crucial factor in assessing the situation, because in Europe in particular, price pressures are essentially coming from increased energy costs and food prices. And if we exclude these two volatile components, **the surprising thing about core inflation is not the absolute value of almost 4%, but the speed with which we have moved from an average inflation rate of around 1.5%,** which lasted for almost 10 years, **to the point where we are now**.

In fact, a closer look shows that this price race started in the summer of 2021, when Covid related lockdowns were lifted in most developed countries and consumers were finally able to resume spending. We believe it is important to understand the fundamental causes of this sudden transition from persistently low inflation, as we experienced in the decade before the pandemic, to a situation characterised by a much higher average level of inflation. This allows us to better assess what the European Central Bank's (ECB) monetary policy will be in the coming quarters and, consequently, to deduce what adjustments we need to make in our investment strategy.

As we all know by now, the closure of many businesses during the pandemic, including ports and airports, led to severe bottlenecks in supply chains. When economies started to reopen, this resulted in a gap between companies' production capacity and pent-up consumer demand. This mismatch led to a price spike that should at least partially unwind when the lockdowns, particularly in China, are finally lifted. In the meantime, to stabilise supply chains, many companies have begun diversifying their supplier networks and taking steps to reduce supply distances. This process, which is still ongoing, has of course involved and will continue to involve costs, some of which companies have passed on or will pass on to consumers.

The summer of 2021 also saw the start of the bull market in oil prices, which was exacerbated, more recently, by the sanctions imposed on Russia, resulting in the price of crude oil nearly doubling to date. As it becomes apparent that the main factor that led to the resurgence of inflation, supply chain bottlenecks, will become less important as supply chains stabilise, it is important to understand under what conditions commodity prices, which for us Europeans are the main drivers of inflation, can fall. The most obvious answer is that an end to Western sanctions against Russia would lead to a significant drop in the price of many commodities, especially oil, gas and cereals. At this point, however, no one can predict when the sanctions will be lifted. So, we must ask ourselves whether there are other factors that could lead to a decline in energy and commodity prices.

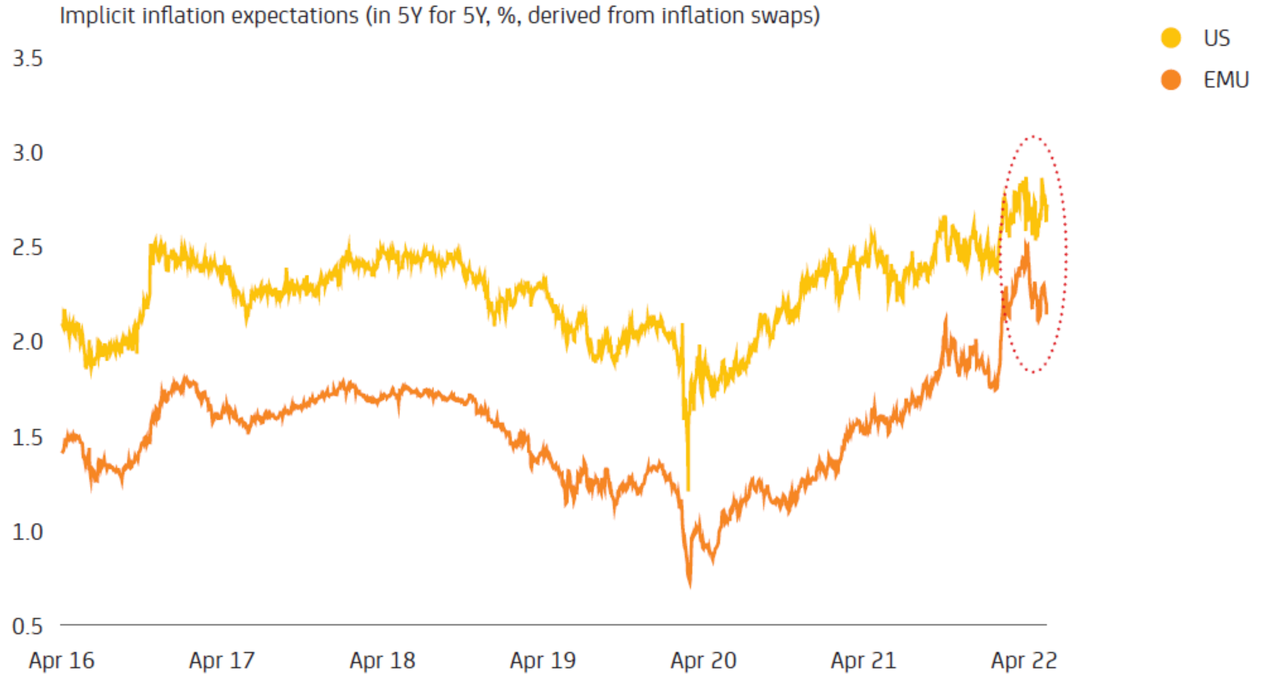
We expect that a general increase in cost of money by central banks, including the ECB, would lead to a slowdown in economic activity and thus to a decline in demand for raw materials. Given the speed with which central banks are adjusting their monetary policies to the new inflationary environment, it is reasonable to expect that global economic activity will soon show more modest growth rates than could have been imagined at the beginning of the year. Whether the landing is soft or hard will largely depend on how quickly or not inflation surrenders in the face of the army of central banks committed to removing monetary stimulus and cooling prices.

Importantly, the drivers of inflation mentioned above are on the supply side of the economy – while a large demand overhang, at least in Europe, is not. However, supply-driven inflation (also called “cost-push inflation”) is usually less persistent than demand-driven dynamics (so-called “demand-pull inflation”). For this reason, among others, excessive inflationary pressure should develop in a limited period of time and likely peak in the coming months.

Markets are already expecting inflation to fall again in the coming years. However, this does not mean that a return to the ultra-low interest rates of recent years is to be expected. Presumably, the phase of ultra-low inflation rates and consequently ultra-loose monetary policy will be a thing of the past. Inflation rates between 2-3%, as expected for the coming years, are not a problem for the economy. On the contrary, inflation rates around 2% are actually healthy.

Moreover, many companies are proving to be very capable of passing on rising costs to a large extent to their customers and thus keeping margins constant. This is also a factor that explains why the market’s expectations of earnings increases for companies are still surprisingly robust. If these expected profit increases are considered together with the price markdowns of the past months, **equities are now quite cheap**, as measured by the price-earnings ratio (P/E ratio). This is another reason why we believe that **equities remain an interesting investment in the medium term.**

EMU INFLATION EXPECTATIONS BACK AGAIN



Source: Refinitiv Datastream, UniCredit Group Investment Strategy